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BEFORE THE
POSTAL REGULATORY COMMISSION

Statutory Review of the System for Regulating Rates and Classes for Market-Dominant Products	: : :	**Docket No. RM2017-3**

COMMENTS OF UNITED PARCEL SERVICE, INC.
(March 1, 2018)

United Parcel Service, Inc. ("UPS") respectfully submits these comments in response to the Commission's Notice of Proposed Rulemaking in this docket (the "NPR") concerning the statutory review of the market dominant rate system established under the Postal Accountability and Enhancement Act ("PAEA").[1] As UPS has noted in its initial comments in this docket and in various other dockets, the United States Postal Service ("Postal Service") has built its competitive products business on the back of its market-dominant customers.[2] The current market-dominant rate system has failed to protect against this result, and UPS agrees with the Commission's conclusion, albeit for different reasons, that the rate system "as a whole has not achieved the objectives of the PAEA."[3]

[1] Notice of Proposed Rulemaking on the Statutory Review of the System for Regulating Rates and Classes for Market Dominant Products, Dkt. No. RM2017-3 (Dec. 1, 2017); 39 U.S.C. § 3622(d)(3).

[2] See Comments of United Parcel Service, Inc. on Advance Notice of Proposed Rulemaking on the Statutory Review of the System for Regulating Rates and Classes for Market-Dominant Products, Docket No. RM2017-3 (March 30, 2017) at 1-3.

[3] Order on the Findings and Determination of the 39 U.S.C. § 3622 Review, Order No. 4257, Dkt. No. RM2017-1 (Dec. 1, 2017) (the "Findings") at 275.

UPS supports the Commission's decision to maintain a rate cap, and urges the Commission to continue to limit increases in the rate cap to changes in the Consumer Price Index ("CPI"). In the event that the Commission decides to grant the Postal Service rate authority above the CPI, UPS calls for modifications to the Commission's proposal to better reflect the PAEA's statutory objectives, and to protect market dominant mailers. As the Commission's proposals stand, the Postal Service would not have appropriate incentives to use the new revenues to maximize operational efficiency and service quality for market dominant mailers, rather than competitive customers. Thus, UPS urges the Commission to develop alternative measures of performance to ensure that the revenue derived from market dominant rate increases above the CPI, if imposed, be used strictly to benefit market dominant mailers.

Finally, UPS proposes accounting and reporting requirements be imposed to ensure that any revenues earned as a result of this proceeding be used solely for market dominant products.

I. The Proposed Structure Of Additional Market Dominant Rate Authority Will Not Accomplish The Statutory Objectives

The Commission proposes unconditionally granting the Postal Service 2% market dominant rate authority per year for five years, plus up to an additional 1% rate authority contingent on certain performance-based measures tied to operational efficiency and service quality.[4] *See* NPR at 38-39. The Commission's goal of granting

[4] The Commission also proposes providing non-compensatory classes an additional 2 percentage points of rate authority per year, a provision which does not appear to be limited to the next five years. *See* NPR at 26, 84.

the Postal Service a path to financial sustainability, however, should not be promoted to the exclusion of the other eight statutory objectives. *See* 39 USC § 3622(b).

UPS respectfully submits that any supplemental market dominant rate authority should be contingent to the fullest extent possible on the Postal Service's achievement of the statutory objectives. UPS therefore proposes that, to the extent any market dominant rate authority above the CPI is necessary, the Commission should grant that rate authority entirely based on certain performance-based measures.

A. The Postal Service Should Not Be Granted Any Unconditional Rate Authority Above The CPI

The Commission's proposal to grant the Postal Service 2% annual supplemental rate authority for five years is excessive. This compounding authority would result in a significant jump in all market dominant rates by the end of the five years. At present, the Commission's proposal attaches no strings to this enormous injection of market dominant revenues. UPS contends that without properly structured incentives, the Postal Service will likely fail to use this new revenue to balance its books and benefit market dominant customers.

The Postal Service does not operate under the incentives to maximize profits and minimize costs that motivate an ordinary for-profit business. Rather, the Postal Service has unique structural incentives to promote volume and scale above all else.[5] Thus, to counteract this tendency, UPS proposes that the Commission grant the Postal Service

[5] *See* Petition of United Parcel Service, Inc. For The Initiation of Proceedings to Make Changes to Postal Service Costing Methodologies, Dkt. No. RM2016-2 (Oct. 8, 2015), at 2, 4, 19; Initial Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Dkt. No. RM2017-1 (January 23, 2017), at 26-27; Declaration of Dennis W. Carlton, Dkt. No. RM2017-1 (March 9, 2017), at 7-10.

no unconditional rate authority. With no guarantee of extracting additional new revenues from market dominant customers in subsequent years, the Postal Service will feel more pressure to downsize where necessary and appropriate. In the NPR, the Commission rightly emphasizes the importance of capital investments to increase operational efficiency in the NPR, but a lack of capital investment is not the only barrier to increased efficiency on the part of the Postal Service. In the face of continuing declines in market dominant volume, the Postal Service must focus on right-sizing its capital plant and operations, as a private for-profit business would be forced to do under the same circumstances. The Postal Service should be given strong incentives to size its capacity to existing volumes, rather than merely making additional capital expenditures to match its present scale and scope of operations. As such, UPS proposes that all additional market dominant rate authority above the CPI should be contingent on the Postal Service's performance in achieving the statutory objectives.

B. Any Rate Authority Above The CPI Should Be Contingent On Market Dominant Products' Actual Performance

The Commission has proposed a system of performance-based supplemental rate authority to incentivize the Postal Service to maximize operational efficiency and maintain service quality. UPS commends the Commission for adopting this approach, and agrees that performance-based incentives are an appropriate means of assuring that the Postal Service not lose sight of the statutory objectives, or otherwise take advantage of its captive market dominant customers. The Commission has proposed granting 0.75% rate authority contingent on operational efficiency, and 0.25% on maintaining service standards. NPR at 26.

UPS respectfully proposes that, to the extent the Commission concludes that any market dominant rate authority above the CPI is necessary, half should be contingent on achievement of objective one, reducing costs and increasing efficiency, and half should be contingent on achievement of objective three, maintaining high quality service standards. *See* 39 USC § 3622(b). This alternative approach will provide the intended incentives without providing the Postal Service with an additional "windfall" rate increase over and above what is necessary to assure financial stability.

Setting aside the issue of what *share* of any additional rate authority is incentive-based, UPS is concerned that the proposed measures of performance in the categories outlined by the Commission will not effectively measure market dominant operational efficiency and service quality. For example, UPS finds fault with the proposal to grant additional rate authority based on maintaining standards rather than actual performance. In recent years, the Postal Service has not met service standards for many of its market dominant products, and the Commission proposes to reward the Postal Service for maintaining standards on paper that it has failed to achieve in reality. UPS thus urges the Commission to develop alternative measures of market dominant operational efficiency and of service quality in order to assure that the performance-based rate authority for market dominant products is, in fact, tied to the Postal Service's performance with respect to those products.

1. The Proposed Operational Efficiency Performance-Based Rate Authority Could Incent The Postal Service To Divert Market Dominant Revenues To Competitive Products

The Commission proposes 0.75% rate authority to be awarded annually if the Postal Service's operational efficiency improvement, as measured by a five-year trailing average of Total Factor Productivity ("TFP") growth, is equal or higher than 0.606, which the Commission describes as the current five year trailing average of TFP growth. NPR at 62. TFP is a ratio that compares total "Workload" (such as weighted volume and delivery points) to total "Input" (such as capital expenditure, labor costs, and material costs). *See* NPR at 58. TFP, however, does not measure efficiency of the market dominant business alone. Rather, TFP measures efficiency of the entire Postal Service enterprise, including the competitive products business, using a methodology that dates back to 1983.[6] As such, the Postal Service could be rewarded with supplemental market dominant rate authority by improving the efficiency of the competitive products business.

The Postal Service could, for example, use the additional revenues gained from rising market dominant rates to purchase parcel-sorting machinery and delivery vehicles specifically designed for parcels. Such capital investments in the competitive products business have the potential to improve the aggregate TFP measure without improving the efficiency of the market dominant business, unlocking additional market dominant rate authority which could then be invested into the competitive products business again. Put simply, there is a risk that granting market dominant rate authority contingent on the Postal-Service-wide TFP measure will result in market dominant mailers bearing even more of the costs of the Postal Service's transition towards competitive products.

[6] *See* Responses of the United States Postal Service to MPA Interrogatories MPA/USPS-T2-2 - 7.a.-c., 8-12, Redirected from Witness Corbett, Docket No. N2010-1 (June 23, 2010), "MPA.T2.3.b.TFP.Formulas.pdf" (the "TFP Formulas"); Findings at 205 n.323.

Worse, TFP measures raw output per input, but does not measure the profitability of that output.[7] As a result, the Postal Service would have an incentive to cut competitive products rates below profit-maximizing levels to drive up competitive product volume, and thus TFP, in order to unlock the performance-based rate authority. The Postal Service already suffers from the effects of incentives to prioritize volume and scale over efficiency, and the Commission should take care not to exacerbate this problem.

The Commission's proposed operational efficiency performance-based rate authority measure would give the Postal Service incentives to double down and burden market dominant customers with additional costs driven by the competitive products Business. UPS has repeatedly described this problem in other contexts before the Commission.[8] Such an outcome clearly undercuts objective nine's requirement that the system "allocate the total institutional costs of the Postal Service between market-dominant and competitive products[,]" 39 USC § 3622(b)(8), and does nothing to support objective one, as that Objective refers to the "incentives to reduce costs and increase efficiency" of market dominant products, not the Postal Service's business in general, 39 USC § 3622(b)(1).

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[7] See TFP Formulas at 19 (describing construction of the "weighted mail volume" measure to calculate the numerator in the TFP formula).

[8] *See e.g.,* United Parcel Service Comments on Postal Service Proposal Thirteen Regarding City Carrier Street Time Costs, Dkt. No. RM2015-7 (Mar. 18, 2015) at 1-5; Petition of United Parcel Service, Inc. For The Initiation of Proceedings to Make Changes to Postal Service Costing Methodologies, Dkt. No. RM2016-2 (Oct. 8, 2015), at 1-7; Initial Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Dkt. No. RM2017-1 (January 23, 2017), at 28-33.

Accordingly, UPS proposes that the Commission require that Postal Service develop parallel TFP measures for the market dominant business and the competitive products business before making TFP the basis for any performance-based market dominant rate increases. It should be a simple matter for the Postal Service to disaggregate the TFP figures for the two enterprises. It would only be necessary to replace the total labor, total capital and total material categories upon which the current TFP measure is based with figures derived from the segments and components set forth in the annual ACD filing, and make a few necessary adjustments to the formula inputs. The resultant market dominant TFP measure would give the Commission and interested parties a more realistic view of the operational efficiency of the market dominant business, and would be a far better benchmark for this purpose than total TFP.

Finally, the Commission's justification for using a 5-year trailing average is not clear. Notably, TFP decreased significantly from FY2015 to FY2016, such that the TFP measure in FY2016 was only slightly above that from FY2013.[9] Furthermore, the Commission also found that average annual TFP growth in the PAEA era, 0.65%, has lagged behind that of the ten years preceding PAEA, when it was 1.03%. UPS urges the Commission to set a higher benchmark for productivity growth to incentivize the Postal Service to do better than it has in the recent past. As present, the proposed figure of 0.606 could reward the Postal Service with greater market dominant rate

[9] *See*, e.g., USPS Annual Tables, FY 2016 TFP (Total Factor Productivity), March 1, 2017. On tab "Tfp-52", the TFP index in 2013 was 1.259, while it was 1.260 in FY16.

authority based on its poor efficiency gains in FY2016.[10] The Proposed Service Quality Performance-Based Rate Authority Does Not Incentivize Actual Service Quality

2. The Proposed Service Quality Performance-Based Rate Authority Does Not Incentivize Actual Service Quality

The Commission has also proposed 0.25% annual market dominant rate authority contingent on the Postal Service meeting certain Service Quality benchmarks. This is a well-intentioned idea, but, once again, the Commission's proposal will not achieve its stated goal. Perplexingly, the proposed rules are undercut by a fundamental point: the service quality measurement will "not examine actual service performance such as time-to-delivery." NPR at 121. Instead, the Commission's examination of the Postal Service's "performance" will be limited to "service standards and business rules[.]" NPR at 71-72. So long as the Postal Service has not lowered its *stated* service standards, the Postal Service will be granted 0.25% additional rate authority, whether or not the Postal Service is actually performing in line with those standards. This is inappropriate.

UPS proposes a commonsense solution: the "service quality-based rate authority" should be contingent on the actual service quality achieved by the Postal Service. NPR at 26. The Commission already reviews service quality performance annually as part of the Annual Compliance Determination, and determining whether the Postal Service's service was satisfactory for a given product will not require substantial

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[10] In the event that the Commission adopts the 0.606 benchmark, UPS urges the Commission to explicitly lay out the calculation underlying that rate. It does not appear to be specified in either the NPR or the associated library references, nor is the methodology obvious to UPS.

additional effort on the Commission's part.[11] This solution will also require a review of the "service standards" and "business rules," as proposed by the Commission, to assure that the Postal Service is not gaming the system by lowering its service quality standards in order to unlock additional rate authority. NPR at 120-121.

UPS proposes that that the service quality performance-based rate authority be authorized for a specific product for a given year if, in that year, the Postal Service achieves full compliance with the service standards and business rules for that product and achieves appropriate specific levels of service for that product, for example, at least 95% on-time delivery, less than 1% lost or damaged deliveries, and/or less than 0.5% of deliveries resulting in a customer complaint.

3. Additional International Market Dominant Revenue Should Be Allocated To Mail Security Improvements

It appears that the Commission has given little attention to the seventh statutory objective, "[t]o enhance mail security and deter terrorism." *See* 39 USC § 3622(b)(7). The volume of market dominant inbound international parcels have almost doubled in the last three years and now number over 498 million per year.[12] The Postal Service did not foresee the rise of international mail as a means of delivering illegal drugs, and as a result there have been significant "struggles in processing and inspecting the mail[,]"[13] Because of disagreements with Customs and Border Patrol (CBP), there is not even a uniform measure for the Postal Service's performance in presenting

[11] See Annual Compliance Determination Report, Fiscal Year 2016, Dkt. No. ACR2016 (Mar. 28, 2017) at 90-156 (reviewing service quality).

[12] Combatting the Opioid Crisis: Exploiting Vulnerabilities in International Mail, Permanent Subcommittee on Investigations, United States Senate (Jan 25, 2018) at 6, 9.

[13] *Id.* at 51-52.

suspicious packages to CBP.[14] Surely the Postal Service should achieve this objective as well. UPS proposes that a reasonable portion of any increase in international market dominant rates should be allocated to programs to achieve objective seven.

C. Any Increase In Market Dominant Rate Authority Should Be Contingent on Additional Financial Transparency and Controls

The Commission's proposals to raise the market dominant rate cap above the CPI are premised on the assumption that the Postal Service will use this new revenue to achieve financial health and benefit market dominant mailers. *See* NPR at 42, 73. The Commission's proposals, however, would give interested parties no way to verify whether the Postal Service is using the new revenue in this way. UPS requests that the Commission require additional financial transparency to assist interested parties. UPS also proposes that the Postal Service be required to clearly state what portion of any capital investments made using the new revenues benefit the market dominant and the competitive products business respectively.

PAEA envisions two Treasury funds, Postal Service Fund and the Competitive Products Fund, to be used to segregate the inflow of revenues from market dominant and competitive products, and to allow financial transparency into the uses of the distinct revenue sources. *See* 39 USC § 2003, 2011. In practice, the Postal Service has regularly commingled the funds. UPS thus reiterates its proposal that the Commission mandate regular deposits into each account and a strict segregation of the revenues that belong in the respective accounts.[15]

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[14] *Id.* at 56-57.

[15] *See* Comments of United Parcel Service, Inc. on Advance Notice of Proposed Rulemaking on the Statutory Review of the System for Regulating Rates and Classes for Market-Dominant Products, Docket No. RM2017-3 (March 30, 2017) at 6.

UPS finally proposes that, if the revenues are used to benefit the competitive products business in undue measure, the supplemental rate authority be rescinded for the following year to the same extent that the revenues benefitted the competitive products business. For example, if it is found that the Postal Service's capital investments with the new revenue equally benefit competitive products and market dominant products, then half the cost of the capital investments would be deducted from the following year's market dominant rate authority. Compliance with this measure could be resolved in the course of the ACR docket.

<u>CONCLUSION</u>

UPS respectfully requests that the Commission limit market dominant rate increases to the CPI. If the Commission concludes that an increase greater than the CPI is necessary, UPS requests that the Commission modify its proposed distribution of supplemental market dominant rate authority to more fully incentivize achievement of the Objectives, and modify the performance-based measures as described above. Finally, UPS requests that the Commission require greater transparency and accountability for any market dominant revenues gained from increases in rates in this proceeding.

Respectfully submitted,

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